Internationalization of Islamic Financial Institutions: Challenges and Paths to Solution

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ABSTRACT

The Islamic Financial Institutions (IFIs) have witnessed a significant growth recently and become a new player in banking industry. As IFIs move towards the international markets, they confront several challenges on internal and external levels. Internally, IFIs still have limited recognition by investors, marginal contribution to the macro economy and limited customer service. Externally, IFIs have lack of communication with other players in the financial markets. Their products are not totally promoted to the international investors and their system is not completely regulated and recognized by central banks. This paper will address these challenges and provide a conceptual framework of solutions.

INTRODUCTION

During the last three decades IFIs have been growing significantly, both domestically and internationally. IFIs witnessed an average annual growth rate of 23% (approximately) during the period 1993-2003, and 20% since 2003 (CIBAFI, 2004).

These new financial firms were established in the emerging market of the Middle East to meet the demand of investors and borrowers who are motivated by profit maximization based on the Islamic law (*Shari'a*). IFIs offer a wide range of Islamic financial innovations starting from the simple contract of profit-sharing agreement (*Mudaraba*), which is similar to time deposit in conventional banks, to Issuing Islamic bonds (*Sukuk*) and derivatives. The growth of IFIs attracted some of the conventional financial firms (i.e., ABN AMRO, Citibank and Dresdner Kleinwort Benson) to add the service of Islamic windows to their clients. Despite the advantages that are embedded in IFIs system and management, IFIs encounter several fundamental challenges to the prospect of being recognized internationally. The challenges exist in local as well as global markets. These advantages and challenges will be discussed through the following questions:

1. What are the advantages that make IFIs different from conventional banks and how the customers perceive these characteristics?
2. What are the challenges that hinder IFIs from being recognized locally and internationally?
3. How can IFIs articulate the proper solutions to meet these challenges?

The paper will be divided into three parts. First part will explain the current situation of IFIs, explaining the factors behind their growth in local and international markets and discusses the advantages of IFIs' system that makes them unique and attractive to all customers. Secondly, it will present a model discussing the two types of challenges before IFIs internationalization: challenges inside the Islamic countries such as the limited recognition of investors to IFIs activities, the limited contribution of IFIs to the country's economy and the limited customer service. The other set of challenges exist outside the non-Muslim countries such as the cultural barriers with the Western countries, the cautiousness of international customers in being involved with IFIs transactions and the misconception of IFIs stereotype. Thirdly, the paper will provide some solutions that can be implemented to facilitate the process of internationalization and provide some lessons to conventional banks on the technical and management sides.

LITERATURE REVIEW

Internationalization has been under discussion for a long period of time, where different authors looked at the process of internationalization from different views. For instance, Buckley and Casson (1976) looked at the transaction costs for intangible assets and the ability to obtain and transfer knowledge across the international markets. This idea has been argued by Hennart (1982) and Caves (1996). Furthermore, Johanson and Vahlne (1977, 1990) and Carpano and Chrisman (1994) argued the influence of internationalization on the firm's performance. In addition, Doz and Prahalad (1984) focused on the organization and management of multinational firms and the balance between international headquarters and national subsidiaries (Martinez and Jarillo, 1991; Paterson and Brock, 2002). Furthermore, Ghemawat (2001, 2003) noted how some types of dimensions among the countries (i.e., cultural, administrative and geographical dimensions) influence the internationalization process. Therefore, they should be studied with the integrative framework of internationalization. These dimensions include the language, religion and social norms (cultural dimension); political, legal and economic sides (administrative dimension); and income, population, and education (geographical dimension). The cultural dimension was studied in detail by Hofstede (2001) and others (Schwartz, 1996; Bond and Chi 1997; Schwartz and Bardi, 2001) where they built a relationship between culture, values and practices. The cultural

dimension has a significant influence on the internationalization process of IFIs. On the other hand, IFIs have high code of ethics derived from the Islamic religion which enhances their Corporate Social Responsibility (CSR), which brought them a favorable image from the stakeholders and enhanced their performance in their early stage. This thought has been developed in literature by Donaldson and Preston, 1995; McWilliams and Siegel, 2001 and Rowley and Berman, 2000.

There is a scarcity of theoretical literature in IFIs internationalization process. Zaher and Hassan (2001) provide a comparative study on the salient features of Islamic banking supervisory system in 15 countries, explaining the lack of regulatory framework in IFIs, which poses a great challenge on IFIs to uniform their standards and policies and mandate them on all IFIs regardless their countries. In addition, Aggrawal and Yousef (2000) argued the economic rationales for the superiority of Islamic financing system over its conventional counterpart. Ebhrahim and Joo (2001) argued that IFIs internationalization process greatly depends on the regulators who should develop a modern financial engineering system for the advancement of IFIs. This would reduce their dependence on the conventional banks for drawing their expertise. Siddiqi (2001) argued that IFIs internationalization is challenged by developing the risk management and analysis tools in Islamic financial theory and practice to hedge against the volatility in the international markets. In addition, IFIs need to educate the international investors with their Islamic ethical foundation that is embedded in their products and their mark-up in each transaction (Hassan, 1999; Baldwin; Humayon and John, 2000; Suseno, 2002).

This paper aims to provide a conceptual framework for the internationalization of IFIs through a model, explaining the challenges that stand against IFIs and the possible solutions to overcome them.

WHAT IS ISLAMIC FINANCING?

Unlike the conventional banking system, the Islamic banking system can be defined as a faith-based system of financial management, which derives its principles from the Islamic *Shari'a*. It promotes profit-sharing in the conduct of banking business as well as prohibiting paying or receiving interest on any transaction (Salleh and Hassan, 2004). This definition asserts the main

pillars of IFIs: guidance by Islamic *Shari'a* through a board of Islamic scholars called the "*Shari'a* Supervisory Board" (SSB) and, most significantly in terms of a reconceptualization in finance, the prohibition of receiving profit (interest) on borrowing and lending cash. The Islamic banking system has been criticized for what has been interpreted as the notion of a risk free reward or return and the lack of recognizing the time value of money (Khan, 1994: 13). This argument is not totally correct because according to the modern economic theory and analysis, Islamic banking is based on equity-based system not on the debt-based system which is the base of conventional banking system (Khan, 2000: 628). This means IFIs offer an uncertain rate of return to the investors and in case of incurring any risk; it should be shared between the bank and the investor. This system allows IFIs to adjust the value of their assets and liabilities according to any changes in the fair market value of the investment. This means the loss is always shared between the IFI and the investors. On the contrary, the conventional banking system does not reflect the changes in fair market value of the investment, instead the bank assumes the loss alone resulting in disequilibrium between the real value of assets and liabilities and ending by negative net worth of the bank (Haron, 2000: 631). The prohibition of pre-determined interest rate on loans puts pressure on IFIs to monitor the borrowers at a reasonable cost and get the exact information about the generated profit because the lender might provide asymmetric information about the real profit. Therefore, the portfolios of IFIs tend to be concentrated in short-term, trade-related assets (Diamond and Dyhvig, 1983: 401). This emphasis on short-term financing leads to an inimical effect on investment, growth and economic development. This concept reflects the social commitment between the bank and the investors in enhancing the economy.

According to Islamic *Shari'a*, IFIs cannot be involved in the production or distribution of specific activities which are forbidden by Islam such as alcohol, pork, and gambling. In replacement, they should invest in long-term assets such as Profit Sharing Agreement (*Mudharabah*), Cost-Plus-Financing (*Murabaha*), Equity Participation (*Musharaka*), and Leasing (*Ijarah*). These activities are based on real assets rather than financial assets (Bahrain Monetary Agency, 2006: 22).

During the last three decades, IFIs have increased substantially in the Middle East and North Africa (MENA) countries and went further to the Far East and Europe. Among all the countries that host IFIs, Bahrain stands as a pioneer in hosting the largest number of IFIs (37 banks) in spite of its smallest size[1]. Bahrain hosts all the regulators of IFIs which will be presented in the following section. The reason behind this growth in Bahrain is the lack of natural resources in the country, which motivated Bahrain government to nourish the Islamic banking industry and make it as one of the main resources of income. In addition, there is no corporate tax in Bahrain, which supports the IFIs system. As Parker (1993) noted that Bahraini planners are keen to portray Bahrain's future as equivalent to Singapore in the Far East.

Global Islamic Economy

So far, the exact size of the global Islamic economy has not been precisely identified. However, for the purpose of this study, we have considered the 57 member nations of Organization of Islamic Countries (OIC) as the primary promoters of IFIs (http://www.oic-oci.org). Previous studies covered part of this economy such as MENA countries, but bypassed the countries where Muslim population is below 50%, as in the ex-Soviet republics, U.K., France and India. The targeted Islamic communities have in common the characteristics of a high level of poverty, debt and high population growth (Moore, 1997: 2). The debt accumulation is often condemned by Islamic economists, especially in those countries who have the opportunity to improve other industries - such as tourism, manufacturing, and natural resources – that can enhance their economy (Chapra, 1985: 84). The second characteristic for Muslim economies is their large defense budgets and the government subsidies to utilities (i.e., electricity, communication, water, and transportation) instead of privatization. The third characteristic is the low availability of employment in the private sector. The public sector accounts for 30-60% of the labor force in most of MENA countries with almost 95% in Gulf Cooperation Council (GCC) countries.[2]

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[1] Bahrain is a set of 33 small islands, located at the North East of Saudi Arabia. It has small production of oil compared to its neighbor countries. According to 2007 statistics, Bahrain has a small population of 708,573 approximately (http://www.infoplease.com/ipa/A0107313.html).

[2] International Monetary Fund - Middle East and Central Asia Regional Economic Outlook (2005)

Most of the Islamic economies are working towards promoting local savings, attracting foreign investments, and reducing their capital expenditures. The most readily available and useful tool for achieving these ends was the creation of a banking system based on Islamic principles.

The Arabian Gulf countries constitute the foundation for IFIs because of their similarity in religion, culture, language and arid geography. They have four out of five largest Islamic banks in the world and maintain the highest concentration of Islamic deposits and capital due to the high income in the region.[3] The members of GCC countries hold 20% of the world's crude oil production and have a Gross Domestic Product (GDP) per capita of more than US$8,000. Therefore, this region was found to be suitable soil for this system to grow in and move around to the other Muslim countries.

Malaysia and South-East Asia are additional financial regions of interest for IFIs, after GCC countries. Malaysia is considered the second most populous Islamic country with 54% of total population after Indonesia which has 90% of population (Moore, 1997: 183). However, Malaysia comes as a pioneer in Islamic banking industry for the whole Southeast Asian region.

From the perspective of conventional banking, the success of IFIs can be gauged by the rush among the conventional banks to open their own Islamic windows, not only inside the Islamic world but in the rest of the world such as Citibank, ABN Amro, HSBC, BNP Paribas, and Bank of America.

In the global market, IFIs are unique in producing Islamic bonds (*Sukuk*) which are different from the traditional bonds and equity instruments. This new tool offers a source of funding based on the profit-sharing concept between IFIs and investors, shifting the risks from the bank side as in the case of traditional bonds to be on a shared basis between the bank and the investors. It enables the bank to exploit their comparative advantages in the loan process and maintain a customer relationship even when loans can not profitably be held on the balance sheet (Alkhan, 2003: 16).

Islamic *Sukuk* are written documents that can be traded in the capital market and bear ownership in tangible assets. They are basically certificates evidencing the *Sukuk* holders'

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[3]Al-Rajhi Banking and Investment Corp.-Saudi Arabia; Kuwait Finance House-Kuwait; Faisal Islamic Bank of Bahrain; Dubai Islamic Bank-U.A.E., and Faisal Islamic Bank of Egypt, which is part of the AlBaraka Banking Group.

ownership in one, or more assets.[4] For instance, Partnership Financing (*Musharaka Sukuk*) and Trust Financing (*Mudaraba Sukuk*) are good examples of *Sukuk,* where investors contribute money to the Islamic bank on the basis of these two instruments, to acquire ownership and profit in real assets. These types of financing reflect the concept of profit-sharing, risk-bearing concept between the IFIs and their investors.

The factors behind the Growth of IFIs

Several factors had contributed to the growth of IFIs, such as the economical growth of GCC countries as a result of the oil discovery and the establishment of the Organization of Petroleum Exporting Countries (OPEC) (Moore, 1997: 7). This unexpected resource of income changed completely the life style in the region and provided the foundation for IFIs. In addition, Saudi Arabia took the lead among the Islamic countries to promote the spirit of Islam through financial support to the Muslim communities in the form of establishing Islamic universities, institutes, and Islamic centers to strengthen the Arabic and Islamic identity (Halliday, 1996). During that time, two Saudi-funded financial firms have been founded (Dallah AlBaraka Group, 1969 and Dar Al-Maal Al Islami Organization, 1981) to support the international development of Islamic banking. After the tragedy of September 11, most of the Arab investors preferred to hold a large portion of their investments in the Middle East in case of another similar event. The IFIs were the best agent to manage their investments. In addition, the central banks in GCC countries and especially in Bahrain, urged the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to set up the accounting and auditing standards for IFIs to protect these investments.

CHALLENGES BEFORE IFIs INTERNATIONALIZATION

There are several challenges hindering the IFIs from being internationalized, which can be classified into two sets of challenges. The first set includes three challenges inside the Islamic countries. First, the regulators' limited influence over IFIs activities and transactions in most of OIC countries leads to investors' limited recognition (Grais, 2004). Secondly, the limited role of

[4] AAOIFI – *Shari'a* Standards No. (18), Investment *Sukuk* (2004-5), p. 4, Akbar (2003), p. 4

IFIs in money and capital markets results in limited contributions to the country's macro economy (Ahmad, Pradhan and Ahmad, 2005). Thirdly, the significant shortage of qualified manpower and management inside IFIs leads to limited customer service (Elhiraika and Hamad, 2003).

The second set includes three challenges outside the Islamic countries. First the SSB influence over the IFIs transactions and activities might be misperceived in non-Muslim countries and create a cultural barrier (Mirza, and Halabi, 2003, 347). Secondly, the different characteristics of IFIs transactions and their religious foundation lead to customers' cautiousness and add extra challenge before IFIs in promoting their products internationally (Iqbal and Mirakhor 1999, 381). Thirdly, the limited capital of IFIs compared with the total capital of the financial institutions in any country leads to marginal recognition by the central banks and enforces the IFIs to accommodate with the existing rules which might not be compliant with Islamic *Shari'a* (Al-Omar and Abdel-Haq, 1996).

Insert Figure 1 about here

Challenges inside the Islamic Countries

Since the conventional banking system is widely spread inside as well as outside the Islamic countries for decades, it gains the clients' trust especially if it is well regulated and actively contributed to the economy. On the other side, IFIs are new player in the financial market; therefore, they strive to compete with the existing system inside the Islamic countries. IFIs are still building up their regulatory system and trying to contribute to the country's economy in line with Islamic *Shari'a*. IFIs are currently recruiting their employees and management from those who work in conventional banks because of the serious shortage in their manpower.

Investors' limited recognition: In the financial industry, the regulators have a significant role in organizing and controlling the transactions and implementing the fiscal policy for the whole country. IFIs are always compliant with the dominant regulations of any country they operate

in; however, they have their own set of regulators that facilitate appropriate interaction with the Islamic *Shari'a*. The first element of the Islamic supervisory network is AAOIFI, which was established in 1991 for the purpose of issuing standards in accounting, auditing, governance, and *Shari'a* for IFIs in accordance with International Financial Reporting Standards (IFRS) (Thomas, Cox and Kraty 2005, 207).

In 2003, the Islamic Financial Services Board (IFSB) was started in Kuala Lumpur to serve as an international-standard setting body of regulatory and supervisory agencies (http://www.ifsb.org). The IFSB is focused on the structured regulatory convergence of supervisory standards. This international convergence is meant to achieve comparable standards of capital measurements and capital standards.

In 2001, the International Islamic Financial Market (IIFM) was founded with the collective efforts of the central banks and monetary agencies of six countries to facilitate secondary markets for Islamic instruments.[5] It has two primary roles: market education and *Shari'a* authentication, which contribute to more self-regulation and promotion of Islamic money and capital markets.

In 2005, the Central Bank of Bahrain established The Liquidity Management Centre (LMC) for the purpose of providing secondary market buyer for Islamic bonds (*Sukuk*). The LMC plays a key role in the creation of an active inter-bank market which will assist Islamic financial institutions in managing their short-term liquidity. The establishment and depth of such inter-bank market will further accelerate the development process of the Islamic banking sector (http://www.lmcbahrain.com).

During the same year of 2005, The Islamic International Rating Agency (IIRA) started operating in Bahrain to assist in the development of the regional financial markets by providing an assessment of the risk profile of entities and instruments which can be used as one of the bases for investment decisions (http://www.iirating.com). The IIRA provides different services of rating such as sovereign ratings and credit ratings which include assessment of an entity's ability to repay the debt obligations in timely manner. Also, it provides the service of *Shari'a* quality rating that includes the assessment of the level of compliance with *Shari'a* principles.

[5] The six countries are Bahrain, Brunei, Indonesia, Malaysia, Sudan and Saudi Arabia. http://www.iifm.net

In addition, there is the Islamic Research and Training Institute (IRTI), which was established under the Islamic Development Bank in Bahrain to sponsor some of the most important analyses of products, regulations, supervision, development economics and risk management (Thomas et al., 2005: 209).

Finally in 2001, the General Council for Islamic Banks and Financial Institutions (CIBAFI) was established in Bahrain to develop and manage a comprehensive database dedicated for IFIs including administrative and financial information since 1998. Currently, CIBAFI is considered the only reliable source of information about IFIs at the global level.[6]

Insert Figure 2 about here

In most of the Islamic countries the central banks are not in practice of their main role in leading the Islamic financial institutions into efficient mobilization of savings and allocation of resources (Khan, 2000: 627). In theory, there is nothing that makes central banks in Islamic economy differ in a major way from the traditional concept of central banking. In reality, the central banks in most of the Islamic countries do not take their essential role of initiating and fostering the development of primary, secondary, and money markets that are approved by SSB. They still lack new innovations which are based on profit-sharing concept, not fixed interest rate.

Also, the central banks do not have an effective role in regulating the standards and practices for IFIs. As a result, their accounting practices were inconsistent and the financial statements were not transparent due to inadequate disclosure (Thomas et al. 2005, 207).

Despite the significant growth of the above regulators, they still have some limitations which make the investors reluctant to trust IFIs in the same way they trust the conventional financial firms. For instance, AAOIFI standards are mandated or used as guidelines only in six countries (Bahrain, Sudan, Malaysia, Qatar, Saudi Arabia and Dubai) out of the 57 countries of OIC. IFSB lacks the authority and power to mandate their standards such as Financial Accounting Standards Board and IFRS. IIFM has still limited access and presentation in OIC and their conferences and seminars are not mature yet. LMC is controlled by Bahrain central market and

[6] General Council for Islamic Banks and Financial Institutions (CIBAFI) - Islamic Finance Directory (2004), p. 4

cannot take independent decisions. These limitations lead to limited recognition from the investors' side.

Limited economic contribution: although the money and capital markets of OIC are still considered as emerging markets, IFIs are restricted by *Shari'a* regulations to effectively take part in those markets. IFIs cannot trade in shares or bonds of any company that generates revenue from alcohol, pork, and similar activities which are prohibited by Islam. Therefore, IFIs have innovated new products in replacement such as *Murabaha* contract, *Tawarroq* contract, *Bei Al Urboon* and *Joa'la contract*[7].

However, these tools are neither available to all IFIs nor significantly contributing to the OIC macro economy. In addition, many Islamic nations are significantly under-banked and this structural fact points the need of growth inside the Islamic community. Currently, most of the Islamic banks are local or regional banks such as Kuwait Finance House and Bahrain Islamic banks. The only Islamic bank that is well established with 203 branches in 10 countries is AlBaraka Banking Group.

Insert Table 1 about here

Finally, IFIs do not have significant contribution to incubators and entrepreneurship inside the member countries of OIC because of their short experience. Their investments are focused on well-established businesses that are approved by SSB only.

Limited customer service: IFIs are in need for accumulation of human capital as it proved to be an important driver of endogenous growth for IFIs (Elhiraika et al., 2003; Barro 1991, 407). According to the Human Development Index (HDI)[8] for the year 2004, Brunei was ranked at 33 and Bahrain

[7] *Murabaha* contract means buying an asset for cash and selling it immediately on credit. In *Tawarroq* contract the Islamic bank purchases the asset on credit and sells it to another one for cash. *Bei Al Urboon* includes setting up a fixed price for a commodity to be delivered in the future. *Joa'la contract* is a conditional promise by the Islamic bank to deliver a specific quantity of a natural asset (i.e., oil, mineral, steel) upon extraction on an agreed date. The commodity trader would pay the pre-determined price for it (Al-Sheahabi 2003, 11-13).

[8] HDI is available with Human Development Report brought out by United Nations Development Programme (UNDP). It is a composite index that measures achievements of a country in different parameters.

at 40, despite the small population of those two countries. Even more alarming indications of lack include Iran, which was placed at 101, Sudan at 139 and Pakistan at 142. The second alarming indicator in this report is the education level, where 73% of the OIC countries occupy the lower half in the ranks for countries listed in HDI. These facts show that Islamic countries and organizations have not been persuasive enough in offering non-Muslim countries with IFIs vision and strategy. It indicates that IFIs success may remain at superficial levels and challenges posed to the conventional financial system may remain feeble otherwise.

Technology, although undergoing tremendous growth, can be said to act as a backbone of the financial sector, as well as being a main driver of market power. It applies not only to the real-time clearing and settlement in money and capital markets, but also to internet-based offerings and Automated Teller Machines (ATMs) which are not fully implemented in IFIs due to their cost and procedures. Even the websites of IFIs are serving advertising purposes more than technical support to customers.[9] Arco Index (Archibugi and Coco, 2004) places 38 out of 57 OIC countries in the lower half of rankings in the set of 162 countries, with 8 out 10 last places and all five last ranks are occupied by OIC countries.[10]

Challenges outside the Islamic Countries

On the global scale, OIC member countries face an economic challenge where the GDP of all member countries together is less than 17% of the GDP of USA and does even reach 12% of the GDP of USA and Japan (Ahmad et al., 2005). Since the economic situation does not support the long-term growth prospects for IFIs, it is important to penetrate other boundaries beyond those of the top GDP countries. In addition, the West is reluctant to accept any approach from OIC countries that might enhance political power in the OIC countries, such as growth in their financial system. The distorted stereotype of Islam in the West constitutes a significant challenge before IFIs to penetrate these boundaries. Also, the difference in culture, language and religion creates another barrier before IFIs towards their internationalization. In addition, the limited capital of

[9] De/Shakeel/Somashekar (2004) De et al. has been dealing in technological impediments in Dubai Islamic bank (U.A.E.) which reflects the current technological situation of the Islamic world.

[10] Archibugi/ Coco (2004), ArCo Index takes into account associated variables with technological changes such as (a) The creation of technology (b) Technological infrastructure and (c) Development of human skills

IFIs compared to the capital of conventional banks results in marginal recognition from the central banks side whether inside or outside the OIC member countries.

Cultural barrier: one of the tangible problems before IFIs is communication between Muslims and the non-Muslim world in general, and between Islamic and conventional banks more specifically. This distance between the two parties have been increased due to the media and the different attacks by some terrorists who distorted the image of Islam in the cultural consciousness of non-Muslims. Therefore, IFIs face great challenge in reshaping this imbalance and bridging this gap between the differing ways of knowing and being. Although the problem exists, there is no Islamic organization charged with the counterbalancing presentation between IFIs and their conventional banking counterpart. IFIs need to arrange for more conferences, seminars and other channels of communications to shorten this gap and create a common ground where the two parties meet. In addition, the SSB should study the products of the conventional banks and encourages the IFIs to invest in the products which are compliant with Islamic Shari'a. This change in attitude will encourage the conventional banking system to change their stereotype of IFIs.

In non-Muslim countries, IFIs have found clashes with mainstream regulations. For instance, treatment of Leasing (*Ijara*) in Islamic banking system is recognized as normal leasing instead of mortgage which changes the concept of *Ijara* from purchasing the asset by the bank and leasing it to customers to a normal lease of real estate. Also, imposing taxes by non-Muslim governments on Islamic religious alms-giving (*Zakat*), leads to double taxation. *Zakat* is treated as a non-operating expense in IFIs financial statements and consequently has no influence on their net income (Ahmed, 2002: 120). Thus, IFIs are required to pay regulatory fees which results in double payments to meet the dual regulations of Islamic and conventional system.

Customer cautiousness: despite the aforementioned advantages of securitization in Islamic banking, international investors are cautious in trading in Islamic *Sukuk* due to their uncommon characteristics. Besides, the taxation system in some countries might have impact (either negative or positive) on securitization process; therefore, issuance of *Sukuk* sometimes can be tax driven.

This lack of support from the tax collection departments hinders the issuance of *Sukuk*. Furthermore, the limited tools available for liquidity management and the lack of an active secondary market add more barriers before IFIs to contribute to the financial markets. The last barrier is caused by the predominance of debt-based modes of financing, which are difficult to transform into negotiable financial instruments. Once *Sukuk* have been created, they can not be transferred to anyone else except at par value. This causes the whole structure of the Islamic financial market to be highly illiquid. Also, it leaves no opportunity in creating secondary financial market (AlKhan, 2003: 28).

Limited recognition of central banks creates a barrier before IFIs in their internationalization process. So far, there is no Islamic central bank inside the OIC member countries, which makes the IFIs dependent on the conventional banks in steering the financial industry. In the non-Muslim countries such as Europe and U.S.A., Islamic banks are not recognized by their central banks because of IFIs marginal role in their economies and the lack of definition to the Islamic banking system. The West still cannot fully comprehend the role of SSB, where banking-type decisions are made by non-bankers, Islamic scholars (George, 1995; Patrikis, 1996). Furthermore, the central banks in OIC member countries lack skills of commercial and investment bankers and capabilities of credit analysis. For example, the central banks in Iran and Sudan use their influence to steer the country's economy by stipulating certain capitals towards specific industries through the reserve requirements. Also, there is no standardization among the SSBs in OIC countries. For instance, if one SSB approves some transactions in one country, it does not secure their approval by another SSB in a different country. Thus, this type of disagreement leads to confusion in the IFIs global strategy and makes it harder for Western regulators to recognize, understand and work with this sector (Clode and Elliott, 1996: 18).

FRAMEWORK OF SOLUTIONS

On the Internal Level

The OIC member countries need to provide support to primary and secondary markets to enhance the contribution of IFIs. Primary markets should focus on promoting new issues of stock, managing subscription operations, attracting individual and institutional savings and

directing them towards productive projects. As a result, new projects will be created to enhance the productivity base and improve the country's economy. The secondary market creates a demand for marginal jobs and support securities trading for liquidation and revenue purposes (Kamel, 2000: 641).

IFIs must also develop more transparency in their financial reporting by eliminating the differences in their accounting treatments; which are mainly attributed to two factors: the differences among the interpretations of *Shari'a* scholars and the differences within regulatory authorities (Karim, 1994). This type of internal self regulations creates accounting differences and misleads the users of financial statements.

Furthermore, IFIs need to standardize their rules of reporting. For instance, different Islamic banks will record the same accounts differently. Some banks (i.e., Jordan Islamic Bank and Qatar Islamic Bank) treat investment accounts that are based on *mudaraba* (profit sharing) as obligations while others (Al Rajhi Banking and investment and Shamil Bank of Bahrain) treat the same accounts as fiduciary investments and accordingly reported them as off-balance sheet accounts (Ahmed, 2001: 111). Also, the collected income from these accounts is recorded using six different methods which makes the income recognition process differs from one bank to another. [11] These types of profit-sharing investment accounts should be recorded as limited-term equity instrument with residual claims.

IFIs regulators need to be proactive in creating new innovations of investments for Islamic banks. For example, they should enhance the inter-bank transactions such as overnight funds and short-term borrowing because Islamic banks cannot use the same tools in conventional banking system because the interest rate is embedded. In addition, central banks need to review the reserve requirements on IFIs because their degree of risk is less than the conventional counterpart (Khan, 2000: 629; Hemat, 1994). Moreover, the regulators in OIC countries should follow Bahrain's model in securing a strong legal system for IFIs and establishing appropriate licensing requirements.

[11] The six methods of income recognition are: up-front; when installments fall due; when installments are paid; equal distribution of income over period of transaction; end of period and constant rate of return. (Ahmed (2001), p. 112)

AAOIFI has recently realized the shortage of professional manpower in IFIs; therefore, AAOIFI started two programs (Certified Islamic Professional Accountant and Certified Shari'a Adviser and Auditor) to enhance the level of customer service inside the IFIs. The first program is in accounting and auditing of IFIs and the second in *Shari'a* supervisory

On the External Level

Although there are differences in cultures, customs and traditions between the East and the West, effective dialogue should take place based on the following guidelines: First, different civilizations complement each other and lead to integration rather than conflict. Secondly, the dialogue leads to recognition of the right of each party and respects it. Effective dialogue will identify the objectives of each party and goes about achieving them gradually and search for common characteristics in each culture and promote them with the aim of creating more understanding (Alghatam and Galal, 2007: 204). IFIs should not be self-absorbed entities; instead, they should have an open mind to the international market, making use of human experience and matching between *Shari'a* requirements and Western norms. Despite the *Shari'a* precautions against certain mechanisms and methods, IFIs can still cooperate with conventional banking institutions in the field of new instruments.

IFIs are still struggling to standardize their accounting requisites. For instance, AAOIFI standards are mandatory only in three countries (Bahrain, Sudan and Jordan) out of the 24 member countries and form the basis for regulatory standards in Malaysia, Saudi Arabia and Qatar (AAOIFI, 2004-5: 23). Therefore, it is essential for IFIs to establish a unified framework to standardize practices in order to be recognized globally such as the Generally Accepted Accounting Principles (GAAP), which cover all the standards of auditing, accounting and financial products in a systematic way (Moore, 1997: 248).

IFIs need to find ways to be internationally accepted by the recognized ratings agencies such S&P 500, Moody's, and IBCA. If IFIs try to argue this approach by establishing their own rating agency such as International Islamic Rating Agency (IIRA) in Bahrain, it will be self-defeating rather than emerging in international market. Recently, Standard & Poor's established a new section for S&P Shariah Indices and Dow Jones also has established Dow Jones Islamic Fund,

which are positive signals towards the world recognition to IFIs. To accelerate the process of acceptance, Islamic scholars need to unify their ratings methodology to be introduced effectively to the international market.

CONCLUSIONS

Globalization has significantly influenced different aspects of our life: economically, politically and financially. The positive side of globalization is the movement of technology and human capital among the countries, while the negative side is lack of governments' ability to control their economy and determine the capital flow. On the financial side, the increase in oil prices flourished the investments in GCC countries and encouraged their governments to support the Islamic financial system. This new system prohibits interest on all transactions and fundamentally based on Islamic laws (*Shari'a*).

Currently, IFIs are existed in Muslims countries as well as some European and American countries. The potential growth of IFIs is quite possible; however, there are some challenges that should be addressed to accelerate the process of their growth. These challenges can be classified into two sets: internal and external. Internally, the investors still rely on the conventional banking system because the current number of IFIs is not large enough to meet the need of OIC member countries, the contribution of IFIs in money and capital markets is restricted by SSB and the customer service inside the IFIs is still premature to attract new clients. Furthermore, IFIs lack a solid regulatory system to unify their products and transactions such as the issuance and trading of *Sukuk*.

Externally, the lack of communication between IFIs and the other members in the financial markets creates a gap between them and leads to lack of awareness about IFIs products and customer cautiousness towards the IFIs activities. In addition, the limited contribution of IFIs to the financial markets results in limited recognition by central banks.

IFIs need to establish effective communication with their counterparts to correct any misunderstanding and facilitate the process of entering the global market. As a result, the clashes with mainstream regulators will be eliminated and the stereotype about IFIs will be corrected in the eyes of non-Muslim countries. Finally, IFIs should establish a comprehensive

training program for their employees to understand the uniqueness of Islamic financial products and help the investors to measure the advantages of dealings with IFIs.

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TABLE "1"

AlBaraka Banking Group Branches

Country	Subsidiary Name	Year of establishment	Branches	Employees
Algeria	Banque AlBaraka D'Algerie	1991	11	461
Bahrain	a- AlBaraka Islamic Bank	1984	4	261
	b- Al Amin Bank	1987	1	32
Egypt	The Egyptian Saudi Finance Bank	1980	15	604
Jordan	Jordan Islamic Bank	1978	66	1,457
Lebanon	AlBaraka Bank Lebanon	1992	5	110
Pakistan	AlBaraka Islamic Bank	1991	15	595
S. Africa	AlBaraka Bank Ltd South Africa	1989	5	150
Sudan	AlBaraka Bank Sudan	1984	23	685
Tunisia	Bank El-Tamweel Al-Tunisi Al-Saudi	1983	6	117
Turkey	AlBaraka Turk Participation Bank	1985	52	909
	Total		203	5,381

Source: AlBaraka Banking Group Prospectus (2006), P. 16

FIGURE "1"

IFIs Challenges towards Internationalization

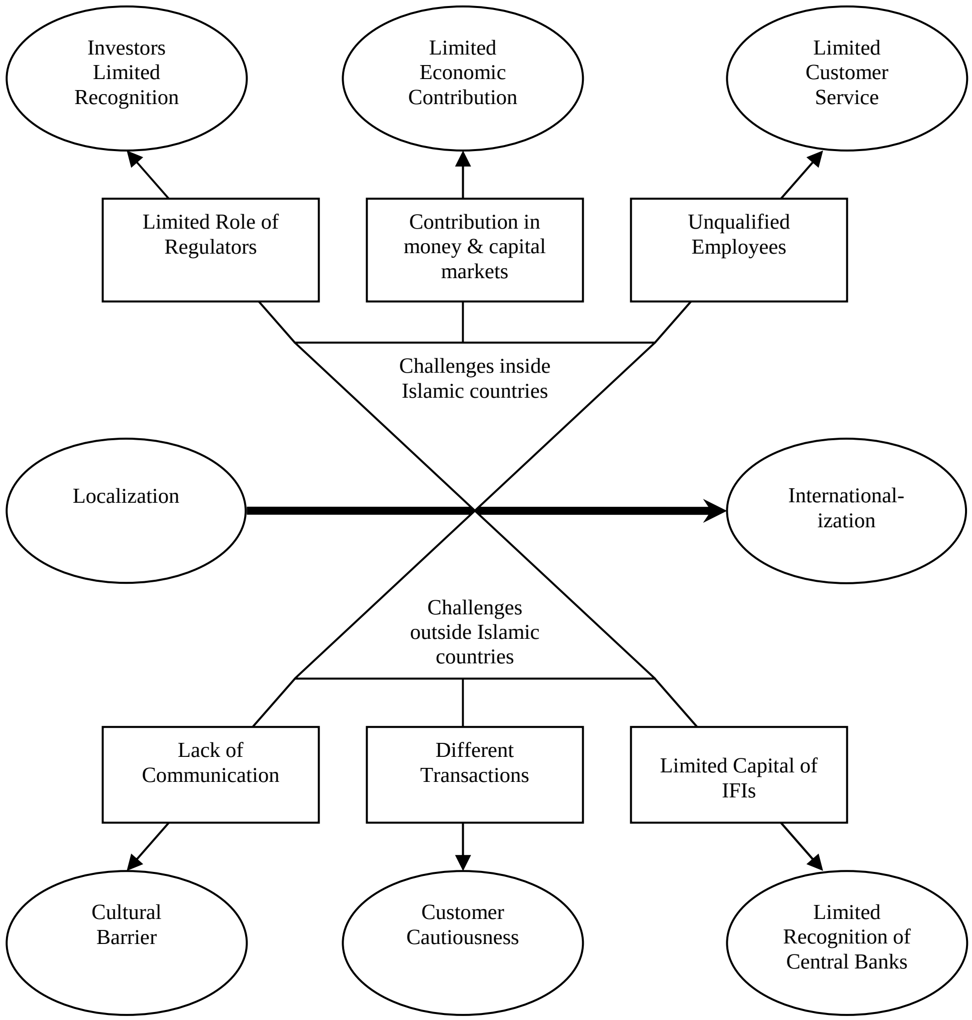
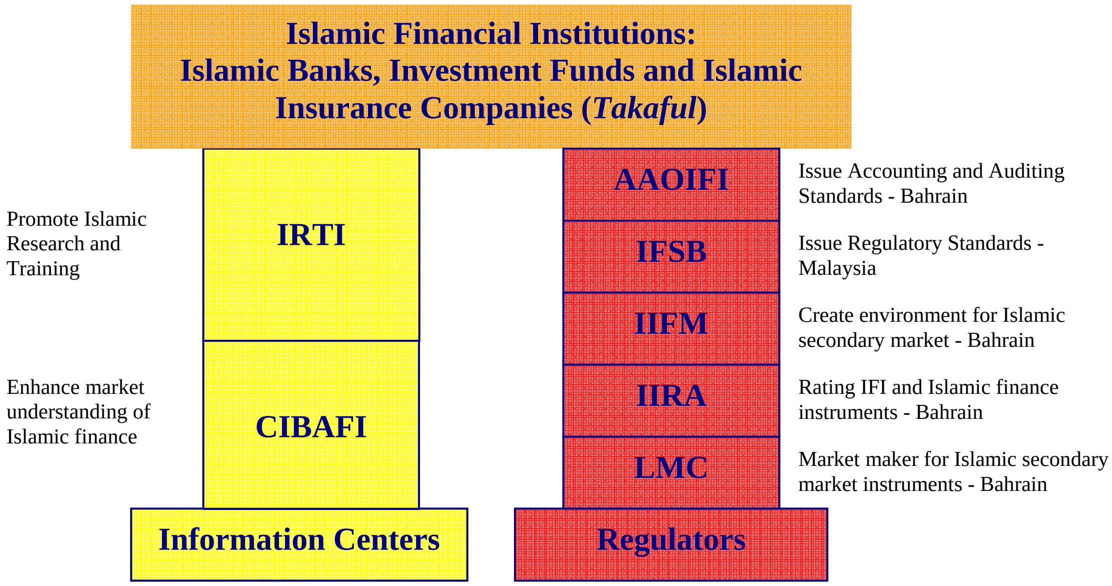


FIGURE "2"

IFIs Regulators and Information Centers



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